Schnader
ATTORNEYS AT LAW
Schnader Harrison Segal & Lewis LLP
NEW YORK PENNSYLVANIA CALIFORNIA WASHINGTON, D.C. NEW JERSEY DELAWARE

CREDITORS' RIGHTS & BUSINESS RESTRUCTURING
ALERT
MAY 2013

Ninth Circuit Overrules Longstanding (But Questionable) Bankruptcy Appellate Panel Precedent to Allow Bankruptcy Court to Re-Characterize Debt as Equity

By Kevin W. Coleman and Valerie Bantner Peo

Bankruptcy trustees and lenders to a potentially insolvent debtor — particularly any lender who has or intends to acquire an equity stake in the borrower — should take note of a recent decision by the U.S. Ninth Circuit Court of Appeals. In *Official Committee of Unsecured Creditors v. Hancock Park Capital II, LP (In re Fitness Holdings Int'l, Inc.)*, __ F.3d __; Case No. 11-56677, slip op., (9th Cir. April 30, 2013), the Ninth Circuit overturned a longstanding – albeit criticized – decision by the Ninth Circuit Bankruptcy Appellate Panel and held that a bankruptcy court has the power to retroactively determine whether an advance of money from a party to a debtor should be characterized as an equity contribution or loan. The decision also clarified the standards a bankruptcy court must apply in making that determination. The decision is important to lenders in that it offers guidance on how to structure loan transactions in order to insulate them from the risk that a bankruptcy court will treat their advances as equity contributions, and it offers trustees and other representatives of a bankruptcy estate a roadmap for treating a less than careful lender not as a creditor, but as an equity owner who stands behind all other creditors for purposes of receiving distributions from the debtor's estate, and for purposes of applying the Bankruptcy Code's avoidance powers.

In *In re Fitness Holdings*, the Official Committee of Unsecured Creditors appointed in the debtor's case sued Hancock Park Capital II, L.P., the debtor's former majority shareholder, alleging that the debtor's payment of nearly $12 million to Hancock Park was avoidable as a constructively fraudulent conveyance under 11 U.S.C. § 548(a). Hancock Park moved to dismiss the complaint arguing that the $12 million repaid pre-existing loans it had made to the debtor, and therefore, the debtor necessarily received "reasonably equivalent value" (*i.e.*, in the form of reduction of that indebtedness) in exchange for the payment which barred the fraudulent conveyance claim in the complaint. Although acknowledging that Hancock Park had infused cash to the debtor and taken promissory notes stating that the infusions were loans, the Creditors Committee responded by contending that Hancock Park's original infusions of cash should be re-characterized as equity contributions, and therefore, the debtor's payment was an avoidable fraudulent conveyance because it did not reduce any "debt" owed to Hancock Park.

The bankruptcy court agreed with Hancock Park dismissing the Creditors Committee's complaint with prejudice, and the district court affirmed that decision. Both courts relied on a 1986 decision by the Ninth Circuit Bankruptcy Appellate Panel which held that the Bankruptcy Code does not authorize the bankruptcy court to re-characterize debt as equity. *In re Pacific Express, Inc.*, 69 B.R. 112, 115 (9th Cir. BAP 1986). The *Pacific Express* court reasoned that because the specific remedy of equitable subordination was expressly provided by Bankruptcy Code § 510(c), but no analogous power of re-characterization is explicitly provided in the Bankruptcy Code, the bankruptcy court could not utilize its general equitable powers under § 105(a) to re-characterize debt as equity. *Id.*

Numerous decisions have criticized *Pacific Express* for failing to properly distinguish between equitable subordination, in which the court determines the priority of a claim based upon equitable factors, and re-characterization, in which the court determines whether an obligation is a claim at all. *See, e.g., In re SubMicron Sys.*, 432 F.3d 448, 454 (3d Cir. 2006); *In re The 3Do Co.*, 2004 Bankr. LEXIS 2345 at *5-6 (Bankr. N.D. Cal. July 2, 2004) (collecting cases critical of *Pacific Express* and holding that re-characterization is a distinct cause of action which can

(continued on page 2)

(continued from page 1)

be decided in the context of a bankruptcy case). The Ninth Circuit agreed that the concepts of re-characterization and equitable subordination were distinct, and thus overruled *Pacific Express* to hold that the bankruptcy court has the authority to determine whether a transaction creates a debt or an equity interest for purposes of Bankruptcy Code § 548. In doing so, the Ninth Circuit joined the Third, Fourth, Fifth, Sixth and Tenth Circuits in expressly recognizing the ability of bankruptcy courts to determine the character of a transaction as debt or equity.

Fitness Holdings, however, took sides in a split among the circuits over what law governs the decision to re-characterize a purported loan as equity. Several circuits apply an 11-factor test derived from federal tax law which is aimed at determining whether the parties intended at the outset to make a loan or equity investment. *See Autostyle Plastics, Inc.,* 269 F.3d 726, 748 (6th Cir. 2001) (the re-characterization factors include, (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments). Under this test, the labels used on instruments documenting a transaction are relevant, but the provisions governing repayment terms and the surrounding circumstances permit a court to conclude that what is ostensibly a loan was in reality intended to be an equity contribution. *See In re Wolverine*, 447 B.R. 1, 28 (Bankr. D. Mass. 2011) (form chosen to document a transaction is "no more than an indicator of what the parties actually intended and acted on").

The Ninth Circuit disagreed with *Autostyle Plastics* application of a standard derived from federal common law, holding instead that the determination of whether a pre-bankruptcy transaction creates a debt or equity investment must be determined under state law. *Fitness Holdings* at *14. But because the Ninth Circuit reversed the dismissal of the complaint on the basis that the lower courts erred in following *Pacific Express* and did not apply the correct legal standard, it did not delve into the question of whether and under what circumstances California law would re-characterize a purported loan as an equity investment, leaving it up to the lower courts to do that on remand. Interestingly, while the Ninth Circuit's decision rejects the application of a federal common law standard articulated in *Autostyle Plastics*, it has no problem if states adopt those same factors into its law. *Fitness Holdings* at *15 (endorsing *In re Lothian Oil*, 650 F.3d 539, 544 (5th Cir. 2011) which held that under Texas law the re-characterization determination is made by reference to a multi-factor test derived from federal tax law). In fact, California is one state that relies on the *Autostyle Plastics* factors in making debt versus equity determinations. *See Hameetman v. California Franchise Tax Board*, B187278 (Cal. App. 12/11/2006) (Cal. App., 2006) (citing the 11-factor federal test applied in *Autostyle Plastics* to determine that a taxpayer's advance to her limited partnership was an infusion of equity, not a loan). Hence, given that "applicable state law" may ultimately incorporate the same federal test that *Fitness Holdings* attempts to distinguish, the hard stance taken by the Ninth Circuit advocating a state law rule of decision will in many cases turn out to be more semantics than substance. ◆

This summary of legal issues is published for informational purposes only. It does not dispense legal advice or create an attorney-client relationship with those who read it. Readers should obtain professional legal advice before taking any legal action.

To learn more about the impact of In re Fitness Holdings *on the characterization of debt in bankruptcy, or, if you have any questions related to the treatment of debt or equity in a bankruptcy proceeding, please contact an attorney in our Creditors' Rights and Business Restructuring Practice Group:*

Richard A. Barkasy, Co-Chair
215-751-2526; 302-888-4554
rbarkasy@schnader.com

Kevin W. Coleman, Co-Chair
415-364-6714
kcoleman@schnader.com

Valerie Bantner Peo
415-364-6735
vpeo@schnader.com

www.schnader.com
©2013 Schnader Harrison Segal & Lewis LLP